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Employee benefit plans industry developments - 1996; Audit risk alerts

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Audit Risk Alerts

Employee Benefit Plans Industry Developments—1996

Complement to AICPA Audit and Accounting Guide
Audits of Employee Benefit Plans



American Institute of
Certified Public Accountants

NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

The AICPA staff wishes to thank the AICPA Employee Benefits Plans Committee and the Office of the Chief Accountant of the U.S. Department of Labor Pension and Welfare Benefits Administration for contributing to this Audit Risk Alert.

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1 2 3 4 5 6 7 8 9 0 PrP 9 9 8 7 6

Table of Contents

	<u>Page</u>
Employee Benefit Plans Industry Developments—1996	5
Industry and Economic Developments	5
Regulatory and Legislative Developments	5
Regulatory Developments	5
Legislative Developments	11
Audit and Accounting Developments	13
Audit Issues.....	13
Audit Developments.....	16
Accounting Issues	17
Accounting Developments.....	17
Frequently Asked Questions	20

Employee Benefit Plans Industry Developments—1996

Industry and Economic Developments

Employee benefit plan issues continue to receive emphasis by Washington policymakers and regulators. Current federal activity focuses on several key areas related to employee benefit plans. Legislation has been introduced in Congress to improve the quality of employee benefit plan audits and to simplify pension plans, and the U.S. Department of Labor (DOL) kicked off a national savings education campaign to encourage Americans to save for retirement. In addition, the DOL initiated an investigation of 401(k) plans for a possible illegal diversion of participant contributions for personal or business use.

Plan sponsors increasingly continue to offer 401(k) and other defined contribution plan options in lieu of traditional defined benefit plans and to offer more investment options for participants. Further, many plan sponsors are outsourcing plan administrative recordkeeping and other functions to third-party administrators or other service providers.

Also, the recent flurry of activity in company mergers and acquisitions, coupled with the many terminations of defined benefit pension plans, has resulted in an increase in employee benefit plan mergers and terminations.

Regulatory and Legislative Developments

Regulatory Developments

PWBA Assessment of the Quality of Employee Benefit Plan Audits. During 1995, the DOL's Pension and Welfare Benefits Administration (PWBA) completed a comprehensive, nationwide study to assess the quality of employee benefit plan audits. The study's primary objective was to assess whether the level and quality of audit work being performed by auditors with respect to audits of employee benefit plans covered under the Employee Retirement Income Security Act of 1974 (ERISA) had improved since 1989, the date of an earlier study performed by the DOL's Office of Inspector General (OIG). PWBA representatives performed on-site workpaper reviews on a statistically

selected random sample of 276 plan audits to determine the extent of compliance with professional auditing standards and ERISA's reporting and disclosure requirements.

The PWBA found that many audits conducted by auditors pertaining to the 1992 filing year continued to fail to comply with professional standards. Certain factors identified by the PWBA are believed to have contributed to this failure. These factors included—

- Inadequate technical training and knowledge on the part of auditors conducting employee benefit plan audits.
- Lack of awareness by auditors of the uniqueness of employee benefit plan audits.
- A failure of audit firms to establish quality review and internal process controls.
- A perception by plan administrators, auditors, or both that employee benefit plan audits are ancillary and provide no useful purpose except to fulfill a governmental regulatory requirement.
- Auditors whose overall practices did not include many audits.
- The failure of auditors to perform necessary audit work.
- The failure of auditors to understand the limited scope audit exemption.

Additionally, the PWBA found a significant number of audit reports that failed to comply with one or more of ERISA's or DOL's reporting and disclosure requirements. The most common reporting and disclosure deficiencies were as follows:

- The auditor's report failed to extend to one or more of the required supplemental schedules.
- The required supplemental schedules failed to include all the necessary information pursuant to ERISA and DOL regulations.
- The plan administrator inappropriately invoked the limited scope audit exemption when the financial institution holding the plan's assets did not qualify for such exemption because it was not a bank or similar institution or an insurance company.
- The statement of net assets was not presented in comparative form as required by DOL regulations.
- The footnotes to the plan's financial statements failed to include certain information required by DOL regulations (for example, a footnote reconciling financial statement amounts to amounts reported in Form 5500 Series Annual Report).

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- The audit was of the trust rather than of the plan.

Ongoing PWBA Review of Plan Financial Statement Audits. The PWBA has established an ongoing quality review program to assess the quality of audit work performed by auditors in audits of plan financial statements required by ERISA. Auditors deemed by the PWBA to have performed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. As of December 31, 1995, 59 referrals had been made to state licensing boards and 270 referrals had been made to the AICPA Professional Ethics Division; of the latter the Professional Ethics Division has resolved 204 cases. Of the resolved cases, 64 had been referred to the AICPA Trial Board or had been settled without a Trial Board hearing, 109 resulted in letters of recommended corrective action, 9 had been found to contain no deficiencies, and 22 had been closed for other reasons. Common deficiencies noted in the referrals included the following:

- Inadequate or no audit program or planning
- Inadequate or no documentation of the auditor's understanding of the internal control structure
- Inadequate or no documentation supporting the audit work performed
- Deficiencies in the auditor's report
- Deficiencies in the footnote disclosures

Form 5500 Reporting of Accumulated Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans. Certain multiemployer health and welfare benefit plan groups have requested that the DOL not enforce the provisions of AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, for multiemployer plans in connection with Form 5500 filings with the DOL. (See the related discussion of SOP 92-6 in the "Accounting Developments" section). As of the date of this Alert, the DOL has not made a formal determination on this matter; however, the AICPA has strongly recommended against the DOL issuing such a waiver. Notwithstanding any DOL action on this matter, if a plan does not adopt the provisions of SOP 92-6, including presenting a statement of the plan's benefit obligations and a statement of changes in the plan's benefit obligations, which are required to fairly present the plan's financial statements in conformity with generally accepted accounting principles (GAAP), the auditor should consider the effect of this departure from GAAP on the audit report. AICPA Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, Pro-

fessional Standards, vol. 1, AU sec. 508), describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP (AU sec. 508.49—.69). A qualified opinion is expressed when the auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and the auditor has decided not to express an adverse opinion. An auditor should express an adverse opinion when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP.

401(k) Plan Contribution Remittance. The DOL issued a proposed regulation that would significantly reduce the maximum period for which employers could hold participant contributions to defined contribution plans, including 401(k) plans. (See *Federal Register*, December 20, 1995.) Current rules require employers to transmit money withheld from employees to their plans as soon as reasonably possible, but in no event longer than ninety days. However, some employers have interpreted the current rule to mean that contributions could be held for ninety days even when those contributions could have been transmitted to the plan in a shorter period.

The proposed regulation would eliminate the ninety-day maximum period and replace it with the same requirements that employers have for depositing withheld income and employment taxes, including Social Security contributions. Under the proposed regulation, all but the smallest employers that sponsor contributory employee benefit plans would be required to deposit employee contributions within a few days of withholding the money from employee wages. Smaller employers would be required to make the deposits by the fifteenth day of the following calendar month. Failing to remit, or untimely remittance of participant contributions, constitutes a prohibited transaction (either a use of plan assets for the benefit of the employer or a prohibited extension of credit) and, in certain circumstances, may constitute embezzlement of plan assets. Additionally, such information should be properly presented on the required Form 5500 supplemental schedule of nonexempt transactions with parties in interest. When plan administrators have failed to disclose this information, plan auditors should consider the effect on the auditors' opinion on the required supplemental schedule accompanying the plan's financial statements.

Pension Payback Program. In March 1996, the DOL announced a Pension Payback program designed to make sure that the money withheld from wages is actually deposited to employees' 401(k) plans. The program, which began March 7, 1996, and ends September 7, 1996, gives employers a six-month "grace period" to contribute, with lost earn-

ings, all funds they deducted from employees' paychecks but failed to deposit in 401(k) plans within required time periods. Employers must also notify the DOL and plan participants. If employers voluntarily come forward, they can avoid criminal and civil penalties.

The program is not available to employers that are now under investigation by DOL. Nor can employers take part if the total amount of withheld participant contributions not forwarded to 401(k) plans is more than the participant contributions withheld from employee wages for calendar 1995.

For specific information concerning program eligibility requirements and the notification process for participation, employers may call (202) 219-4377 or write the Pension and Welfare Benefits Administration, U.S. Department of Labor, P.O. Box 77235, Washington, DC 20013-7235.

PWBA Reporting Compliance Program. The PWBA continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting and disclosure requirements. Through 1995, the PWBA has rejected over 4,200 filings and imposed over \$64 million in civil penalties under ERISA section 502(c)(2), which provides for penalties of up to \$1,000 per day against plan administrators that fail to file acceptable annual reports on a timely basis. In addition, the PWBA continues to actively identify and target both late filers and nonfilers. Over 590 late filers and nonfilers have been identified and assessed over \$49 million in late filing and nonfiling penalties.

Delinquent Filer Voluntary Compliance Program. In April 1995, the PWBA initiated an ongoing Delinquent Filer Voluntary Compliance (DFVC) program designed to encourage filer compliance by allowing plan administrators that failed to file or filed their Form 5500 reports late to apply for relief from full delinquency penalties. This program was designed to be less burdensome on small plans and to balance the PWBA's limited resources between enforcement and compliance objectives. Participation in the DFVC program constitutes a waiver by plan administrators to receive notice of assessment of civil penalties under ERISA section 502(c)(2) and to contest the DOL's assessment of the penalty amount. Participation in the DFVC program does not preclude assessment of nonfiling or late-filing penalties by the Internal Revenue Service (IRS). The IRS has recommended that plan administrators participating in the DFVC program attach reasonable cause statements to their original Form 5500 filings.

In addition, plan administrators of certain employee benefit plans for highly compensated individuals, known as *top hat* plans, and apprenticeship and training plans that missed their filing deadlines may

submit statements and elect an alternative method of compliance in lieu of making annual report filings. Filers participating in the DFVC program will be assessed \$2,500 per statement. To date, the DOL has received 2,490 annual report filings and 118 statements by top hat plans and apprenticeship and training plans totaling \$7.3 million in reduced penalty assessments. Questions concerning the DFVC program should be directed to the PWBA's Division of Reporting Compliance at (202) 219-8770.

PWBA Outreach and Customer Service Efforts. The PWBA encourages auditors and plan filers to call its Division of Accounting Services at (202) 219-8794 with ERISA-related accounting and auditing questions and questions regarding preparation of Form 5500. Questions concerning filing requirements should be directed to the Division of Reporting Compliance at (202) 219-8770.

In addition to handling technical telephone inquiries, the PWBA is involved in numerous outreach efforts designed to provide to practitioners information needed in understanding ERISA's reporting and disclosure requirements. Questions on those outreach efforts should be directed to the Office of the Chief Accountant at (202) 219-8818.

Finally, the PWBA has published the following booklets to assist practitioners in understanding ERISA's reporting and disclosure requirements:

- Trouble-Shooter's Guide to Filing the ERISA Annual Reports
- Reporting and Disclosure Guide for Employee Benefit Plans
- MEWAs Under ERISA—A Guide to Federal and State Regulation
- Guide to Summary Plan Description Requirements
- Fidelity Bonding Under ERISA
- Exemption Procedures Under Federal Pension Law

These publications may be ordered by writing to Publications Desk, PWBA-DPA, Room N-5656, U.S. Department of Labor, 200 Constitution Avenue, NW, Washington, DC 20210.

DOL Interpretive Bulletin Relating to Participant Investment Education. In January 1996, the DOL issued regulations titled "Interpretive Bulletin Relating to Participant Investment Education" (Interpretive Bulletin), which provide guidance on the distinction between nonfiduciary education and fiduciary investment advice in the context of participant-directed employee benefit plans, primarily 401(k) plans. In defining *fiduciary* under ERISA, section 3(21) of ERISA indicates broadly that a fiduciary includes anyone who "renders investment advice for a

fee or other compensation, direct or indirect, with respect to any money or other property of [a] plan, or has authority or responsibility to do so." The Interpretive Bulletin provides examples of certain categories of information and material that constitute nonfiduciary investment education rather than fiduciary investment advice. The Interpretive Bulletin specifies four broad categories of information and services that, alone or in combination, will be treated as nonfiduciary employee education. These categories include plan information, general financial and investment information, asset allocation models, and interactive investment materials. CPAs providing education to participant directed plans should become familiar with the Interpretive Bulletin to determine whether their activities in connection with providing participant investment education may subject them to fiduciary status.

Legislative Developments

Pension Audit Improvement Act of 1995. The Pension Audit Improvement Act of 1995 (S. 1490) was introduced in the Senate on December 20, 1995, by Senator Simon (D-IL) and cosponsored by Senators Jeffords (R-VT), Leahy (D-VT), and Boxer (D-CA). The proposed legislation is designed to improve audits to better protect participants and beneficiaries. Among other things, S. 1490 proposes to—

- Repeal the limited scope audit exemption for plan years beginning on or after January 1 of the calendar year following the date of enactment.
- Redefine who meets the requirements of an independent qualified public accountant (IQPA) under ERISA. The bill would mandate external quality control reviews and continuing professional education (CPE) requirements for auditors who conduct ERISA audits. Auditors must have undergone qualified external quality control reviews of their accounting and auditing practices during the three-year period immediately preceding each engagement. In addition, auditors must have completed at least eighty hours of CPE or training that contributes to their professional proficiency within the two-year period immediately preceding each engagement. At least twenty hours must have been completed during the one-year period immediately preceding each engagement, and at least sixteen of the eighty hours must relate to employee benefit plan matters.
- Require the plan administrator to report certain events (for example, irregularities) directly to the DOL within five business days after the plan administrator first has reason to believe (or after the plan administrator has been notified by the auditors) that an event

may have occurred with respect to the plan. If a plan administrator fails to report such an event to the DOL, the auditor would be required to report such information directly to the DOL.

- Require the plan administrator to notify to the DOL about the auditor's termination of the engagement within five business days after termination. If the plan administrator fails to provide such notification to the DOL or if the auditor disagrees with the reasons given in the notification, the bill would require the auditor to notify the DOL of the termination, giving the reasons.
- Subject auditors to civil penalties of up to \$100,000 for failing to comply with the above reporting provisions.

Auditors should be aware that this proposed legislation, if enacted, could substantially change the way benefit plan audits are conducted and could affect their audit practices. Auditors should be alert for new developments in this area.

Pension Reform. Recently, attention has been focused on underfunded retirement plans and how the Pension Benefit Guaranty Corporation's (PBGC's) growing accumulated deficit will affect its ability to meet its obligation to guarantee employees' benefits under most private-sector defined benefit pension plans. In December 1994, the Retirement Protection Act of 1994 (the Act) was enacted as part of the General Agreement on Tariffs and Trade (GATT) legislation. The Act is intended to increase the security of the pension system and improve the PBGC's ability to meet its obligations to plan participants. It modifies existing rules to encourage employers to more fully fund their defined benefit pension plans by imposing new minimum funding rules for plans with more than one hundred participants and by raising the full-funding limit. The Act amends various qualification requirements, including limiting the ability of sponsors of underfunded plans to select interest and mortality assumptions for purposes of calculating their minimum contributions, and modifies the interest and mortality assumptions used for calculating lump-sum distributions from defined benefit plans. Other key provisions of the Act include—

- Elimination of the cap on variable-rate PBGC premiums, which could increase premiums for underfunded plans.
- The addition of new participant notice and PBGC reporting requirements.
- Establishment of a new PBGC program for missing participants in standard terminations.
- Elimination of quarterly contributions for well-funded plans.

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- Elimination of the excise tax for some nondeductible contributions.
 - Extension until the year 2000 of a company's ability to transfer excess pension assets to a 401(h) account to pay current retiree health benefits.

The Act's provisions generally are effective for 1995 plan years.

Such changes could, among other things, affect a plan's tax qualification status. Auditors should make inquiries of, and obtain representations from, management concerning compliance with the laws and regulations and the prevention of violations that may cause disqualification. The auditing procedures ordinarily applied in assessing a plan's tax status as part of a financial statement audit are discussed in paragraph 12.03 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

Audit and Accounting Developments

Audit Issues

Plan Merger Effective Dates. The recent flurry of activity in company mergers and acquisitions, coupled with the many terminations of defined benefit pension plans, has resulted in an increase in employee benefit plan mergers. Because the effective date of a merger, according to the plan documents, often is prior to the actual transfer date of the related plan assets, confusion exists about how to determine the correct merger date for Form 5500 and financial statement purposes. Procedures the auditors may wish to apply to determine the proper merger date include discussion with management and service providers regarding the intended date of merger; review of plan documents, amendments, minutes of plan meetings, correspondence with service providers, and other pertinent plan information; and testing the transfer of assets from former custodian to current custodian. Auditors need to use judgment in each merger situation based on the procedures described above to determine the proper merger date for Form 5500 and financial statement purposes.

OCBOA Financial Statement Disclosures. Some plan administrators prepare plan financial statements on a modified cash basis or another comprehensive basis of accounting (OCBOA) rather than in conformity with GAAP. Often, such financial statements do not include information about accumulated plan benefits. Paragraphs 9 and 10 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), require that auditors apply essentially the same criteria to

OCBOA financial statements as they do to financial statements prepared in conformity with GAAP. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in paragraph 4 of SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411). Thus, as noted in paragraph 13.22 of *Audits of Employee Benefit Plans*, plan financial statements prepared on an OCBOA should disclose information regarding accumulated plan benefits or accumulated benefit obligations, as applicable. Certain other disclosures also may be appropriate. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or an adverse opinion on the financial statements.

Limited Scope Audit Exemption. ERISA section 103(a)(3)(C) allows auditors to limit the scope of their testing of investment information prepared and certified by a qualified trustee or custodian, such as a bank, trust company, or similar institution or an insurance company. However, this limited scope audit exemption does not apply to information prepared and certified by broker-dealers and investment companies or to noninvestment information, such as benefit payments, employer-employee contributions, loans, and receivables.

Auditors should also be aware that the limited scope audit exemption does not apply to assets held by a broker-dealer or an investment company unless the investment company owns a subsidiary bank that can certify the investment information. The exemption also does not apply to investment information other than that certified by a qualified trustee or custodian or to other noninvestment information. The scope limitation and the corresponding limitation of the auditor's work extends only to investments and related investment activity certified by the qualified trustee or custodian. Plan investments not held by a qualified trustee or custodian, and all noninvestment related information (for example, contributions receivable, benefits paid, other expenses), should be subjected to the same audit procedures as those for a full scope audit. The auditor's responsibilities in limited scope engagements are discussed in detail in paragraphs 7.47 and 7.48 of *Audits of Employee Benefit Plans*.

Claims Incurred but not Reported. Paragraph 39 of SOP 92-6 requires that self-funded health and welfare benefit plans measure the cost of claims incurred but not reported (IBNR) at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims

(paragraph 4.37 of *Audits of Employee Benefit Plans*). However, financial statement preparers and auditors often are unclear about what the estimated ultimate cost should include. In some cases, plans may inappropriately be using a “lag” approach (recording known amounts that relate to the period covered by the financial statements that are reported subsequent to year end but prior to the issuance of the financial statements) to estimate the ultimate cost of IBNR claims and do not consider any future obligations of the plan relating to conditions that existed as of the end of the period but that had not been reported prior to the issuance of the financial statements.

SOP 92-6 states that the estimated ultimate cost of IBNR claims should reflect the plan’s obligation to pay claims to or for participants, regardless of status of employment, beyond the financial statement date pursuant to the plan provisions or regulatory requirements. For example, an individual contracts a terminal disease or has a catastrophic accident in December. The claim is reported to the plan subsequent to the plan’s calendar year end. Treatment is ongoing and is expected to continue throughout the next year. The plan does not require any return to work and fully covers all services. The actuarial present value of the obligation for all future payments to be made as of the plan year end (December) should be included as a benefit obligation in IBNR.

Auditors should be aware that the calculation of IBNR amounts is often quite complex and may require the use of actuarial estimates. In such cases, the auditor should discuss with the plan administrator the need for the plan to engage an actuary and should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

Trend Toward Outsourcing. With the trend toward daily valuation of 401(k) plans, more benefit plans are using service providers to execute transactions and maintain accountability on behalf of the plan administrator. Oftentimes the plan does not maintain independent accounting records of transactions executed by the service provider. For example, many plan sponsors no longer maintain participant enrollment forms detailing the contribution percentage and the allocation by fund option. In these situations, the auditor may not be able to obtain a sufficient understanding of the internal control structure relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those elements of the internal control structure maintained by the service organization. This understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70, *Reports on the Processing of Transactions by*

Service Organizations (AICPA, *Professional Standards*, vol. 1, AU sec. 324) for the service organization. If the SAS No. 70 report is unavailable, the auditor should consider other appropriate procedures to obtain sufficient evidence to achieve the audit objectives. For example, if participant enrollment forms are unavailable from the plan sponsor, the auditor may wish to confirm the information directly with the participants. Alternatively, the auditor could consider requesting the enrollment forms from the service provider or visiting the service provider to perform the necessary testing. (See chapter 6 “Internal Control Structure” of *Audits of Employee Benefit Plans*.)

Investment in Derivatives. Employee benefit plans sometimes use derivatives as risk management tools or as speculative investment vehicles. The use of derivatives often increases audit risk. Although financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor’s approach to achieving related audit objectives may differ because the notional and contractual amounts of certain derivatives—such as futures, forwards, swaps, options, and other contracts with similar characteristics—generally are not recognized in the financial statements. Auditors should understand both the economics of derivatives used by employee benefit plans and the nature and business purpose of the derivatives activities. To the extent the derivatives meet the definition of financial instruments as defined in Financial Accounting Standards Board (FASB) Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*; No. 107, *Disclosures about Fair Value of Financial Instruments*; and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), the disclosure requirements set forth in those Statements must be met.

Audit risk considerations presented by the use of derivatives are discussed in *Audit Risk Alert—1995/96*. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (product no. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Audit Developments

SAS No. 70 Auditing Procedure Study. In April 1996, the AICPA Auditing Standards Board (ASB) issued an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations*, that provides guidance on implementing SAS No. 70 to

service auditors engaged to issue a report on the internal control structure policies and procedures of a service organization and to user auditors engaged to audit the financial statements of an entity that uses a service organization. Examples of a service organization include a bank trust department that invests and holds assets for a plan or a third-party service that processes claims or performs recordkeeping services for a plan.

SAS on Using the Work of a Specialist. Plan auditors frequently use the work of actuaries and appraisers to corroborate assertions in plan financial statements (for example, the actuarial present value of benefit obligation amounts and asset values). SAS No. 73 provides guidance for auditors who use the work of such specialists in audits performed in accordance with generally accepted auditing standards (GAAS).

Accounting Issues

401(h) Plans. A number of employers have amended defined benefit pension plans that they sponsor to provide for the payment of certain health benefits for retirees, their spouses, and dependents in addition to the normal retirement benefits. The Internal Revenue Code (IRC) permits defined benefit pension plan sponsors to fund (subject to certain restrictions and limitations) all or a portion of their postretirement medical obligations through a 401(h) account in their defined benefit pension plans. Contributions to a 401(h) account may be used only to pay health benefits. Auditors should be aware that the plan assets set aside in a 401(h) account are not assets available to pay pension benefits and should not be characterized as such in the plan's financial statements. The AICPA Employee Benefit Plans Committee currently has an SOP project under way to provide guidance on the accounting for and disclosure of 401(h) features of both defined benefit pension plans and health and welfare benefit plans. The committee expects to issue an exposure draft in mid-1996. This project would not affect plan accounting and reporting for 1995 plan year-end reporting; however, auditors should be alert for further developments on this project.

Accounting Developments

Health and Welfare Benefit Plans. In August 1992, the AICPA Employee Benefit Plans Committee issued SOP 92-6, which clarified several accounting and reporting requirements set forth in chapter 4 of *Audits of Employee Benefit Plans* and updated chapter 4 to incorporate Statements issued by the FASB.

SOP 92-6 is now effective for most employee benefit plans. It was effective for single-employer plans with more than five hundred participants for plan years beginning after December 15, 1992; for single-employer plans with no more than five hundred participants for plan years beginning after December 15, 1994; and for multiemployer plans for plan years beginning after December 15, 1995. When a plan adopts the SOP, the plan must adopt it in its entirety.

Accounting changes adopted to conform to the provisions of the SOP should be made retroactively. When there has been a change in accounting principles that has a material effect on the comparability of the plan's financial statements, SAS No. 58 states that auditors should refer to the change in an explanatory paragraph of their report. Because ERISA requires comparative statements of net assets available for plan benefits, it will be necessary to restate the prior year's statement of net assets in the year of adoption in an ERISA audit to comply with the provisions of the SOP. In addition, because accumulated benefit obligations are not reported on Form 5500, plans should include a note to their financial statements reconciling the amounts reported in the financial statements to amounts reported on Form 5500, as described in paragraphs 12.16 and A.51 of *Audits of Employee Benefit Plans*.

Valuation of Insurance and Investment Contracts. In September 1994, the AICPA Employee Benefit Plans Committee issued SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, which provides guidance on how those plans should report investment contracts issued by insurance companies, banks, thrift institutions, and others. In addition, the SOP provides guidance for determining the fair value of investment contracts held by all types of plans. The SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of the SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995.

Certain investment contracts that are held by health and welfare plans and defined contribution pension plans may be reported at contract value. In the current economic environment, some of those contracts may have been issued by what are now troubled insurers. In those cases, the auditor should be aware that continuing to carry the assets at contract value may not be appropriate, because the plan may not recover the entire contractual amount. When addressing contracts issued by troubled insurers, auditors should consider the guidance in FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59).

Risks and Uncertainties. In December 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-6, *Disclosure of*

Certain Significant Risks and Uncertainties, SOP 94-6 which requires entities to include in their financial statements disclosures about (1) the nature of operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations. The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending subsequent to December 15, 1995.

Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure. Examples of SOP 94-6 disclosures affecting employee benefit plans are as follows:

- *Nature of Operations*—The SOP requires a description of the major products or services the reporting entity sells or provides and its principal market. *Audits of Employee Benefit Plans* currently requires that plans disclose a description of the plan agreement. However, it allows plans that publish or make available a plan description to exclude certain disclosures. SOP 94-6 requires full disclosure of the nature of operations regardless of whether a plan description is published or made available.
- *Use of Estimates*—According to the SOP, financial statements should include an explanation that financial statements prepared in conformity with GAAP require the use of management's estimates. Benefit plan financial statements generally include various elements that are subject to estimates (for example, actuarial present value of accumulated benefits, fair value of certain investments such as real estate or nonreadily marketable securities) and thus a disclosure regarding the use of estimates would be required.
- *Certain Significant Estimates*—The SOP requires disclosures of certain significant estimates when certain criteria are met. The SOP includes examples of items that may be based on estimates that are particularly sensitive to change in the near term and would need to be disclosed. Included in the examples are amounts related to long-term obligations, such as amounts reported for pensions and postemployment benefits. Thus, certain defined benefit pension and health and welfare plan financial statements may need to present this disclosure.

Impairment of Long-Lived Assets. In March 1995, the FASB issued FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*,

vol. 1, sec. I08), which establishes accounting standards for the impairment of long-lived assets. The Statement is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted by the Statement.

Auditors of the financial statements of employee benefit plans should consider management's policies and procedures for determining whether all impaired long-lived assets, for example, real estate owned by the plan for plan operations for which the value has been impaired, have been properly identified. Auditors should evaluate management's estimates of future cash flows from asset use and impairment losses following the guidance of SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342).

Frequently Asked Questions

The following questions and answers are adapted from an article written by David M. Walker, Arthur Andersen LLP, appearing in the June 1996 *Journal of Accountancy*. They include frequently asked questions received during the past year by AICPA Employee Benefit Plans Committee members and the AICPA staff. Many of the questions relate to issues identified by the DOL as problem areas during its recently completed review of selected 1992 employee benefit plan audit engagements.

1. *Which entity—the plan or the trust—has to be audited under ERISA?*

While some trust activity must be audited in any plan audit, the audit report must be on the plan, not on the trust. For example, if several plans are funded through a single master trust, each plan that meets ERISA's audit requirements (generally funded plans with one 100 or more participants as of the beginning of the plan year) must be audited and a report issued. A sole audit report on the master trust with separate columns for each plan's financial information will not satisfy ERISA's audit requirements.

2. *Can a plan report detailed master trust information in its financial statements in lieu of submitting a separate master trust filing with the DOL?*

No. DOL regulations require that a separate master trust filing be submitted to the DOL.

3. *Do plan auditors have to issue a report on a master trust's financial statements?*

No. The master trust's financial statements do not have to be audited. However, the auditors generally have to audit certain

master trust activity in order to express an opinion on any related plan's financial statements.

4. *Can the plan meet the GAAP disclosure requirements related to master trust information by attaching a copy of the master trust's filing?*

No. The required summary master trust disclosures, as described in paragraphs 2.28 and 3.27 of *Audits of Employee Benefit Plans*, must be in the notes of the applicable plans' financial statements.

5. *Does the plan have to report fund information in a participant-directed plan that is funded via a master trust?*

Yes. GAAP requires disclosure of certain fund information by participant-directed and nonparticipant-directed accounts.

6. *Which institutions may certify investment information under ERISA's limited scope audit exception (ERISA section 103)?*

Banks, insurance companies, trust companies, and certain other financial institutions that are subject to regular and periodic examination by a state or federal agency may do this. As a result, mutual fund companies, broker-dealers, and selected other entities (such as associations) generally are not eligible for this statutory scope exemption unless they have set up a separate trust company or other eligible institution that has custody any related ERISA plan assets.

7. *Does ERISA's limited scope audit exception apply to benefit payments and plan administrative expenses if the trustee certifies such information?*

No. The exception applies only to investment-related information that is certified both as to completeness and accuracy by an eligible institution.

8. *Should plan auditors extend the scope of their testing to include functions performed by certain third-party service organizations (such as third party welfare plan claims administrators and savings plan administrators) when conducting an ERISA limited scope audit?*

Yes. However, the limited scope audit exception does not apply to certain areas that need to be examined in connection with any GAAS audit, including ERISA limited scope audits (for example, benefit payments, and administrative expenses). The nature and scope of testing will depend on a variety of factors (such as the kinds of functions being performed by the third-party service organization; what type of report was generated in compliance with SAS No. 70; and the results).

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9. *Will the Securities and Exchange Commission accept an ERISA limited scope audit report (for example, a disclaimer of opinion) in connection with a Form 11-K filing?*

No.

10. *Will the DOL reject a Form 5500 filing if the auditor's opinion on the plan's financial statements is qualified for any reason other than the limited scope audit exception?*

Generally yes. However, the DOL has informally stated that it will not reject a Form 5500 filing if the auditor's opinion is qualified solely for failure to present comparative benefit obligation information in connection with the adoption of SOP 92-6. Current-year benefit obligation information must be presented, however.

11. *If the plan auditor issues a qualified opinion on one or more supplemental schedules (for example, because of failure to provide historical cost information) and an unqualified opinion on the plan's financial statements, does the plan report that a qualified opinion has been issued in response to question 26b on Form 5500?*

No. This question addresses the opinion on the plan's financial statements and not on the supplemental schedules.

12. *What method does the DOL require be used for determining historical cost on the supplemental schedules?*

The DOL generally will accept any clearly defined and consistently applied method of determining historical cost that is based on the initial acquisition cost of the related asset (for example, first in, first out or average cost). For the reportable transactions schedule, historical cost must be the original historical cost as of the date of acquisition of the asset.

13. *Do the disclosure requirements in FASB Statement No. 107 apply to employee benefit plan assets?*

Yes. Most employee benefit plan assets are carried at fair value, and no additional disclosures are necessary for those assets under FASB Statement No. 107. However, disclosure of fair value is required for financial instruments not carried at fair value. The most frequent example is investment contracts held by defined-contribution pension or welfare benefit plans that are carried at contract value as required by SOP 94-4, *Reporting on Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*. The disclosure amounts relating to such contracts typically are calculated by employing a discounted cash flow approach based on prevailing interest rates for similar instruments.

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14. *If a plan has performed a voluntary tax compliance review and has discovered certain operational violations, what authoritative guidance should be followed for reporting and disclosure in the plan's financial statements?*

Such matters should be handled in accordance with FASB Statement No. 5.

15. *What are an auditor's responsibilities in connection with prohibited transactions?*

Under GAAS, auditors must design an audit to detect any prohibited transactions that would have a direct and material effect on the plan's financial statements. The auditor also has the responsibility to be watchful for any prohibited transactions. If the auditor becomes aware of a potential prohibited transaction, he or she must ascertain whether the transaction is prohibited. If it is, it must be disclosed on the applicable supplemental schedule of nonexempt transactions, irrespective of quantitative materiality. In such cases, the auditor should consider consulting the plan's legal counsel.

16. *What should a plan auditor do if he or she discovers that required information has been omitted from one or more required ERISA supplemental schedules?*

If any required information (for example, historical cost), items (for example, participant loans), or transactions (such as prohibited transactions) are not disclosed in the applicable supplemental schedules, the auditors should modify his or her report on the applicable supplemental schedule(s). Paragraphs 13.14-.18 of *Audits of Employee Benefit Plans* provides guidance in this area.

17. *What responsibilities does an auditor have in connection with a plan's tax status?*

Under GAAS, auditors would ordinarily review any applicable Internal Revenue Service tax determination letter or opinion letters of qualified tax counsel relating to the plan and the associated trust. If these are not available, the auditor should review those aspects of the plan document relevant to the determination of the plan's tax-exempt status. In addition, the auditor should make informed inquiries of the plan administrator or other appropriate plan representatives regarding the plan's operations and changes in plan design that could jeopardize its tax-exempt status. Because of the complexity of this area and the related risks, the auditor should ensure that those responsible for performing the tax status review are qualified to do so.

18. *Are participant loans considered plan investments?*

Yes. Therefore, they should be shown as investments on the plan's financial statements and on the supplemental schedule of assets held for investment. They can be shown as a single line item on the schedule of assets held for investment if the conditions noted in the instructions to Form 5500 are met. Generally, participant loans would be shown as a separate participant-directed investment column in any applicable plan's financial statements if they represent more than 5% of the plan's net assets.

19. *Are audit workpapers subject to examination by the DOL?*

The DOL says that ERISA gives it legal access to audit workpapers since they support the audited financial statements that are must be attached to the Form 5500 annual report filing. As a result, the DOL conducts on-site reviews of audit workpapers as part of its ongoing enforcement efforts.

20. *What action does the DOL take when it determines that auditors have performed substandard audit work?*

The DOL may reject the client plan's Form 5500 filing (of which the audited financial statements are a part), potentially subjecting the plan administrator to a civil penalty of \$300 per day (up to \$50,000) calculated from the day after the Form 5500 filing was due. The DOL also refers significantly deficient work to the AICPA Professional Ethics Division and state licensing authorities.

21. *What should the auditor do when he or she becomes aware that a plan has not made the required filings?*

The auditor has no express responsibilities under GAAS. However, he or she may wish to advise the plan administrator of the filing requirements and the availability of the DOL's delinquent filer voluntary compliance program, which gives plan administrators an opportunity to file overdue annual reports and pay reduced civil penalties.

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This Audit Risk Alert supersedes *Employee Benefit Plans Industry Developments—1995*.

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Auditors should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1995/96*, which

can be obtained by calling the AICPA Order Department at the number below and requesting publication number 022180.

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) 862-4272. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

